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No. 86-261

In The
Supreme Court of the United States
October Term, 1986

GARFIELD TRUST COMPANY,
Appellant,

v.

NEW JERSEY DIRECTOR,
DIVISION OF TAXATION,
Appellee.

ON APPEAL FROM THE SUPREME COURT OF NEW JERSEY

MOTION TO DISMISS AND BRIEF IN SUPPORT THEREOF

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QUESTION PRESENTED

Does the Corporation Business Tax, *N.J.S.A.* 54:10A-1 *et seq.*, by virtue of including a net income tax base as part of its measure, constitute a franchise tax.

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MOTION TO DISMISS

Pursuant to Rule 16(1)(b) of this Court, the Attorney General of the State of New Jersey, on behalf of the Appellee, New Jersey Director, Division of Taxation, hereby moves to dismiss this appeal because it does not present a substantial federal question.

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

CONSTITUTIONAL PROVISIONS

Supremacy Clause, U.S. Const., Art. VI, cl. 2:

> This Constitution and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Borrowing Clause, U.S. Const. Art. I, § 8, cl. 2:

> Section 8. The Congress shall have Power . . .
>
> To borrow money on the credit of the United States. . . .

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FEDERAL STATUTE

Federal Public Debt Statute, Rev. Stat. § 3701, 31 U.S.C. § 742[1] *as in effect in 1976, the year involved in this case:*

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[1] The present Federal Public Debt Statute, 31 U.S.C. § 3124, as amended by Pub. L. No. 97-258, Sept. 13, 1982, reads in relevant part:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except—
>
> (1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and
>
> (2) an estate or inheritance tax.

> Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

New Jersey Statutes

Corporation Business Tax Act:

N.J.S.A. 54:10A-1 *et seq.*

———o———

STATEMENT OF THE CASE

The New Jersey Corporation Business Tax Act *N.J.S.A.* 54:10A-1 *et seq.*, is a franchise tax exacted by the State of New Jersey from every domestic and foreign corporation,

> . . . for the privilege of having or exercising its corporate franchise in this State, or for the privilege of doing business, employing or owning capital or property, or maintaining an office, in this State. . . . [*N.J.S.A.* 54:10A-2].

The tax is computed by adding together prescribed percentages of a net worth tax base and a net income tax base. *N.J.S.A.* 54:10A-4(d), 4(k) and 5. Net worth is broadly defined under *N.J.S.A.* 54:10A-4(d) to include the stockholders' book equity in the corporation with certain additional adjustments not relevant in this proceeding. *F. W.*

Woolworth Co. v. Director, Division of Taxation, 45 *N.J.* 466, 468, 213 A.2d 1 (1965). The statutory definition of net worth is thus all inclusive and encompasses the principal value of all securities owned by the corporate taxpayer. *Motor Finance Corp. v. Director, Division of Taxation,* 129 *N.J. Super.* 19, 23, 24, 322 A.2d 180, 182, 183 (App. Div. 1974), certif. den. 66 *N.J.* 319, 331 A.2d 19 (1974). The entire net income base is defined under *N.J.S.A.* 54:10A-4(k) to be reflective *prima facie* of the taxable income reported for federal income tax purposes. In addition, the New Jersey Legislature provided for an adjustment to the federal taxable income base to include any income from interest on any kind of security, stock or indebtedness. *N.J.S.A.* 54:10A-4(k)(2).

This appeal questions whether the Corporation Business Tax Act is a "franchise" and thus an indirect tax on net worth and net income, which represent the measure of the tax. This case brings into question the viability of *Werner Machine Co. v. Director, Division of Taxation,* 17 *N.J.* 121, 110 A.2d 89 (1954), aff'd 350 *U.S.* 492 (1956), in which this Court and the Supreme Court of New Jersey held that the Corporation Business Tax was a franchise tax and that the net worth measure of the tax included Federal Treasury notes and bonds within the meaning of 31 *U.S.C.* § 742. The latter statute, generally referred to as the Federal Public Debt Statute, 31 *U.S.C.* §742 (recodified as 31 *U.S.C.* § 3124, authorizes states to impose a tax on the principal value and/or interest income of federal debt obligations owned by corporate taxpayers under a "nondiscriminatory franchise or other nonproperty taxes in lieu thereof." Appellant, Garfield Trust Company, maintains that the Corporation Business Tax, because it includes a net income measure that was not part of the

Corporation Business Tax at the time *Werner Machine* was decided, was no longer a franchise tax and cannot impose a tax measured by the income and principal value of the federal obligations owned by it in accordance with the Federal Public Debt Statute.

During the 1976 tax year at issue, the appellant, a banking corporation organized under the laws of New Jersey, owned various debt obligations issued by federal and New Jersey agencies.* The principal value of such debt obligations was reflected in the net worth base reported by the appellant in its 1976 Corporation Business Tax return and the income from such obligations was included in the net income tax base in said tax return.

Garfield Trust filed a refund claim with the appellee, Director, Division of Taxation, in the amount of $89,897 for the tax year 1976 claiming that the principal value and interest income from federal and New Jersey debt obligations were not subject to inclusion in the tax bases of the Corporation Business Tax. Garfield Trust asserted two primary issues in claiming that federal and New Jersey debt obligations should not be included in either of the tax bases of the Corporation Business Tax. First,

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* Included in these obligations were bonds and notes issued by the Treasury Department of the United States, by other Federal agencies (e.g. Federal Home Loan Bank, International Bank for Reconstruction), by various New Jersey authorities (e.g. New Jersey Health Care Facilities, New Jersey Housing Finance Agency), by New Jersey county governments (e.g. Camden County), by local New Jersey governing bodies (e.g. Atlantic City, Jersey City) and by various regional, county and municipal authorities and school districts of New Jersey (e.g. Dover Sewerage Authority, Ocean County Sewerage Authority).

it maintained that the Corporation Business Tax was not a franchise tax and thus, under 31 *U.S.C.* § 742, federal obligations could not be included in the measure of the tax. Second, Garfield Trust contended that, under various New Jersey statutes, the principal and interest income from debt obligations issued by New Jersey governmental agencies were exempt from inclusion in the measure of the Corporation Business Tax. Garfield Trust asserted that the Corporation Business Tax was a "discriminatory" franchise tax within the meaning of 31 *U.S.C.* § 742 by virtue of according a preference to New Jersey-issued obligations in contrast to taxing federal obligations. Such a discriminatory result required the similar exemption of the federal obligations from the measure of the Corporation Business Tax.

The New Jersey Director of Taxation denied Garfield Trust's refund claim, whereupon Garfield Trust filed a complaint with the New Jersey Tax Court challenging that denial. The Tax Court, in an opinion dated June 19, 1984, sustained the Director's denial of the refund claim and held that (App. 21A):

1. The Corporation Business Tax is a bona fide franchise tax and is thus an indirect tax on a corporation's net income and net worth.

2. The principal value of debt obligations issued by New Jersey authorities and the interest income generated by such obligations are subject to inclusion in the net worth and net income tax bases, respectively, of the Corporation Business Tax.

3. The Corporation Business Tax is a "nondiscriminatory" franchise tax which accords no tax preference

to New Jersey-issued obligations relative to debt obligations issued by federal agencies.

The New Jersey Superior Court, Appellate Division, upon appeal, affirmed the Tax Court decision (App. 19A). The Supreme Court of New Jersey granted certification and, in a comprehensive opinion reported at 102 *N.J.* 420, 508 A.2d 1104 (1986) (App. 1A), also affirmed the Tax Court determination. The Supreme Court of New Jersey analyzed the Corporation Business Tax and found that the inclusion of a net income tax was merely another measure of a franchise tax that was enacted simply to increase revenues. The court concluded that the Corporation Business Tax always has been and still is an annual franchise tax. *Werner Machine* was deemed to have retained its vitality through recent decisions by this Court and the Supreme Court of New Jersey (App. 10A).*

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* The Supreme Court of New Jersey also determined that, as a matter of state law, the principal value and interest income from debt obligations issued by New Jersey governmental entities were subject to inclusion in the net worth and net income tax bases of the Corporation Business Tax. The Supreme Court of New Jersey held that such state obligations were not statutorily accorded a tax preference relative to federal debt obligations, thus resulting in the inclusion of both types of debt obligations in the measure of the Corporation Business Tax. This parity of treatment between federal and New Jersey obligations unequivocally established the Corporation Business Tax as a nondiscriminatory franchise tax within the meaning of the Federal Public Debt Statute (App. 18A). The issue regarding the status of the New Jersey debt obligations under the Corporation Business Tax is not raised in the jurisdictional statement filed by Garfield Trust since this is a matter of state law clearly binding on the Federal courts. *See Wainwright v. Goode,* 464 *U.S.* 78, 83, 84 (1983).

ARGUMENT

THIS APPEAL DOES NOT PRESENT A SUBSTANTIAL FEDERAL QUESTION AND SHOULD BE DISMISSED SINCE THE HOLDING BY THIS COURT IN WERNER MACHINE CO. v. NEW JERSEY DIRECTOR, DIVISION OF TAXATION, ESTABLISHING THE CORPORATION BUSINESS TAX AS A FRANCHISE TAX, IS STILL VIABLE AND CLEARLY PRECEDENTIAL TO THIS CASE.

31 *U.S.C.* § 742 establishes a broad exemption of federal obligations from state and local taxation:

> Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

This exemption from state taxation applies to Treasury notes and bills as well as to the obligations issued by instrumentalities of the United States, such as the Federal Farm Credit Banks. *Memphis Bank and Trust Co. v. Garner,* 459 *U.S.* 392, 396 (1983). The decisions by this Court have treated § 742 as essentially a restatement of the constitutional rule of tax immunity established in *McCulloch v. Maryland,* 4 *Wheat* 316, 4 *L.Ed.* 579 (1815). In accordance with that rule,

> States may not impose taxes directly on the Federal Government, nor may they impose taxes the legal incidence of which falls on the Federal Government. [*United States v. County of Fresno*, 429 *U.S.* 452, 459 (1977)].

However, in the event the economic but not the legal incidence of a state tax falls on the Federal Government, the tax generally does not violate the constitutional immunity if it does not discriminate against entities or individuals holding federal property. *Memphis Bank and Trust Co. v. Garner, supra*, 459 *U.S.* at 397.

The Corporation Business Tax was enacted in 1945 (New Jersey laws 1945, chapter 162) and consisted initially only of a net worth tax base. Since the inception of the tax, the Division of Taxation has consistently included in the net worth base all federal and state securities, notwithstanding that such securities might be otherwise exempted from taxation. This position was sustained in *Werner Machine Co. v. Director, Div. of Tax.*, 17 *N.J.* 121, 110 A.2d 89 (1954), aff'd 350 *U.S.* 492 (1956), in which the New Jersey Supreme Court considered the validity of including in the net worth base the face value of federal bonds otherwise exempt from taxation by § 742. The Supreme Court of New Jersey determined that the Corporation Business Tax was "an annual franchise tax" and "that in no way does the statute tax property in the commonly occupied sense of taxation of property." 17 *N.J.* at 125, 110 A.2d at 91. The court noted that,

> We find nothing in the statute indicative of a tax upon the property owned by the corporation, nor upon a franchise as "property." [17 *N.J.* at 126, 110 A.2d at 91].

The court held that since the Corporation Business Tax was not imposed upon the underlying property of a corporation but rather upon its franchise, § 742 did not operate to exempt the value of the federal bonds from inclusion in the taxable net worth.

The New Jersey Supreme Court analyzed the Corporation Business Tax in *Werner Machine* and noted the following:

1. The tax was imposed upon the corporation for the privilege of having or exercising its corporate franchise in this State, for the privilege of doing business, employing or owning capital or property, or maintaining an office in New Jersey under *N.J.S.A.* 54:10A-2.

2. Dissolution, merger, consolidation or withdrawal of authority to exercise the corporate franchise was prohibited unless the franchise tax was paid as required by the statute.

3. Foreign corporations were subject to forfeiture of their charters to operate in New Jersey under *N.J.S.A.* 54:10A-21 if the tax were not paid.

4. Domestic corporations were subject to forfeiture of their charters under *N.J.S.A.* 54:10A-22 if the tax were not paid.

These factors were deemed indicative of a state franchise tax. The Supreme Court of New Jersey concluded that,

> . . . the Corporation Business Tax Act (1945), *supra*, is a valid franchise tax and that the federal bonds are properly included in the calculations of net worth. . . .
>
> The tax is imposed upon the corporation for the privilege of exercise by the corporation of corporate powers in this State. The measure of the tax is the net worth or present value of the investment in the corporation and the tax is not levied upon the property owned by the corporation, nor is it measured by the nature or source of the securities in which some or all of the assets of the corporation are invested. It may be said that a franchise tax imposed upon a corporation for the privilege of doing business under a corporate charter is based upon the potential of the corporation for doing business under the sanction and protection of the laws of the State. *Cf. Corporations—Theory of Organizational Franchise Taxation—Michigan Franchise Tax,* 48 *Mich. L. Rev.* 1130, 1132-1133 (1950). [17 *N.J.* at 126-127, 110 A.2d at 91-92].

This Court affirmed the decision by the Supreme Court of New Jersey:

> . . . we find no basis in this instance for not accepting the state court's conclusion that this tax is not imposed directly on property held by the corporation. . . . Since the tax remains the same whatever the character of the corporate assets may be, no claim can be sustained that this taxing statute discriminates against the federal obligations. And since this is a tax on the corporate franchise, it is valid despite the inclusion of federal bonds in the determination of net worth. This Court has consistently upheld franchise taxes measured by a *yardstick which include tax-exempt income or property,* even though a part of the economic impact of the tax may be said to bear indirectly upon such income or property. [350 *U.S.* at 493-494; emphasis supplied].

This Court's decision in *Werner Machine* clearly established that the Corporation Business Tax, as a franchise tax, was not directly imposed upon the underlying property of a corporate taxpayer and, therefore, § 742 did not operate to exclude the federal bonds from the net worth measure of the tax.

The holding in *Werner Machine, supra,* has been consistently followed by the New Jersey Division of Taxation not only with regard to including in the net worth base state and federal obligations but also with respct to including the interest income from such obligations in the net income base. The latter base was enacted in 1958 (New Jersey laws 1958, chapter 63) and became effective for the 1959 tax year and thereafter. *N.J.S.A.* 54:10A-32. The Director, by regulations initially adopted in 1959 and currently reflected as *N.J.A.C.* 18:7-5.2(a)(2), has explicitly provided that entire net income shall include,

> All interest income from sources within the United States which has not been included in computing Federal taxable income, including interest on State and Muncipal bonds and certain obligations of the United States and its instrumentalities, less interest expense incurred to carry such investments, to the extent such interest expense has not been deducted in computing Federal taxable income; . . .

The policy of the New Jersey Division of Taxation to include the interest income generated by tax exempt federal and state obligations in the entire net income base for Corporation Business Tax purposes is clearly proper in light of *Werner-Machine v. Director, supra.* The same rationale which supported the inclusion of the value of federal bonds in the net worth base applies equally to in-

clude the interest income from such bonds or other obligations in the entire net income base. The Corporation Business Tax, being a franchise tax, is not a direct tax on a corporation's income or net worth but merely utilizes such values as a measure of the tax. The Corporation Business Tax, therefore, properly includes in its tax bases the value of all federal obligations held by corporate taxpayers and the income generated thereby.

Garfield Trust maintains that the holding of *Werner Machine* is no longer applicable to the Corporation Business Tax because the tax is founded currently upon a much broader base than the tax considered in *Werner Machine,* because the tax, by virtue of the addition of the entire net income tax base, was transformed into a "direct" tax upon net income and because the tax no longer constitutes a franchise tax. It, therefore, maintains that § 742 now exempts the federal bonds and the interest therefrom from both the net worth and net income tax bases of the Corporation Business Tax.

The contentions of Garfield Trust simply disregard the statutory language of the Corporation Business Tax and ignore opinions by this Court that a state franchise tax may include a net income base as a measure of the tax. The Corporation Business Tax was enacted in 1945 on the recommendation of the *Report of the Commission on Taxation of Intangible Property,* (1945) which suggested the imposition of a "franchise tax" in lieu of the existing *ad valorem* tax on intangible property. See *United States Steel Corp. v. Director, Division of Taxation,* 38 *N.J.* 533, 539, 186 A.2d 266, 269 (1962). The tax was assessed in 1945 for conducting in New Jersey the same privileges that were incorporated in the tax for the 1976 tax year, namely

(1) conducting the corporate franchise in this State, (2) doing business in this State, (3) employing or owning capital or property in this State or (4) maintaining an office in this State. The exercise in New Jersey by a corporate entity of the same threshold activities found to be part of a franchise tax under the holding in *Werner Machine* remained as the triggering mechanism for imposing the tax in 1976. The privileges, the exercise of which in New Jersey constitute the incidence of the tax, have thus remained constant and continue to establish the Corporation Business Tax as a franchise tax.* Also, the same features of the Corporation Business Tax which were itemized in *Werner Machine* as indicative of a franchise tax are still incorporated as part of the tax in 1976. Thus, the Corporation Business Tax still requires the payment of the tax in order for a corporation to dissolve, merge, consolidate or withdraw from New Jersey (*N.J.S.A.* 54:50-13) and still provides for the forfeiture of a corporate charter of a domestic or foreign corporation for nonpayment of the Corporation Business Tax (*N.J.S.A.* 54:10A-21 and 22).

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* Some or all of these privileges constitute the basis for imposing franchise taxes by other states.

State franchise statutes typically impose a tax, as in California, on "every corporation doing business within . . . this State . . . for the privilege of exercising its corporate franchises within this State." Unlike many statutes, the California provision goes on to define "doing business" as "actively engaging in any transaction for pecuniary profit." In other States, such as New York, the imposition clause defines the subject of the tax as embracing not only "the privilege of exercising its corporate franchise, or of doing business," but also specifies "employing capital or . . . owning or leasing property . . . or maintaining an office in this state" among the subjects taxed. [1 *Hellerstein, State Taxation* (1983), ¶ 6.3 at 213].

Notwithstanding that the fundamental nature of the Corporation Business Tax has not changed since the decision by this Court in *Werner Machine,* Garfield Trust in addition maintains that a corporate tax measured in part by net income is *per se* not a franchise tax. This Court, in *Tradesmens National Bank of Oklahoma City v. Oklahoma Tax Commission,* 309 *U.S.* 560, 564 (1940), held that:

> The power of a state to levy a tax on a legitimate subject, such as a franchise, *measured by* net assets or *net income including tax-exempt federal instrumentalities or their income* is . . . well settled . . . . [Emphasis supplied].

Moreover, in *Memphis Bank and Trust Co. v. Garner, supra,* this Court considered whether a Tennessee Bank Tax imposed on net income was a nondiscriminatory franchise tax within the meaning of § 742. In finding that the Tennessee tax was discriminatory, by virtue of according a preference to obligations issued by the state, this Court, nevertheless, clearly recognized the validity of a franchise tax measured by net income. *See also First National Bank of Atlanta v. Bartow County Board of Assessors,* 470 *U.S.* —, 84 *L.Ed.*2d 535 (1985); *American Bank and Trust Co. v. Dallas County,* 463 *U.S.* 855 (1983).

In addition, as noted in 1 *Hellerstein, State Taxation* (1983), ¶ 6.1 at 208-209, the traditional state corporate franchise tax had its origins in certain legal concepts prevalent in the eighteenth and early nineteenth centuries:

> The traditional corporate tax was an excise on the privilege of doing business in the State. In part, this was due to the eighteenth and early nineteenth century view of the corporate franchise as a special benefit conferred by the State and typically granted by special act of the Legislature for the conduct in corporate form

> of a designated limited type of business. In addition, a franchise or excise tax on the privilege of conducting business in the State would avoid the constitutional equality and uniformity provisions of some States. The States were following the model of the Federal corporation income tax, which had been drawn as an excise on the privilege of doing business in order to avoid the fate of the Federal "direct" net income tax that had been invalidated by the United States Supreme Court for lack of apportionment in accordance with the population. The corporation's property was already being taxed under the State's property tax. Hence, if a tax on the value of the corporation's capital stock, or on its net income, constituted a property tax, the levy would violate the uniformity and equality provisions of some States. But a franchise tax on the privilege of conducting business in the State is an excise, and even though the levy is measured by the value of the corporation's capital stock or its net income, the tax would not be subject to the uniformity and equality provisions in the many States whose constitutional restrictions had been interpreted as having application only to property taxes.

Thus the incorporation of a net income base as the "measure" of a franchise tax is a legitimate and common facet of a state corporation tax statute and clearly does not transform the tax into a direct imposition on the net income. *Hellerstein, supra,* ¶ 2.3 at 34, 35.

In summary, it is clear that the holding of *Werner Machine* has not lost its vitality. The same Corporation Business Tax denominated as a franchise tax in *Werner Machine* has not fundamentally changed. The inclusion of a net income measure as part of the Corporation Business Tax subsequent to the decision in *Werner Machine* did not transform the tax into a nonfranchise tax. Therefore, the Corporation Business Tax constitutes a nondiscriminatory

franchise tax that properly includes the principal and income of federal obligations within the meaning of the Federal Public Debt Statute.

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CONCLUSION

It is respectfully submitted, therefore, that the appellant has not presented any substantial federal question which warrants the further attention of this Court and that this appeal should be dismissed.

Respectfully submitted,

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